DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0041
Indiana Corporate Income Tax
For the Tax Years 1993 through 1996

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ISSUES

I. **Estimated Rent Expenses** – Adjusted Gross Income Property Factor.

Authority: IC 6-8.1-5-1(b); 45 IAC 3.1-1-43.

Taxpayer argues that the audit erroneously included an estimated amount for rent expenses attributable to its Indiana manufacturing site.

II. **Property and Inventory Factors** – Adjusted Gross Income.

Authority. IC 6-3-2-2(c); IC 6-8.1-5-1(b).

Taxpayer disagrees with the audit's calculation of the amount of inventory maintained at an Indiana distribution site which was closed in 1994 and sold in 1995. Taxpayer similarly disagrees with the value the audit attached to the distribution site property.

III. **Installation and Delivery Receipts** – Gross Income Tax.

Authority: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); IC 6-2.1-2-3; IC 6-2.1-2-5(9); 45 IAC 1.1-1-2; 45 IAC 1.1-6-10.

Taxpayer argues that the audit erred in assessing high rate gross income tax on receipts obtained for the delivery and installation of carpet and floor coverings because the taxpayer received the money while acting in an agency capacity.

IV. **Deduction for Interest on Federal Obligations**.

Authority: IC 6-3-2-2; Allied-Signal, Inc. v. Director, Div. Of Taxation, 504 U.S. 768 (1992); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax

Ct. 1999); 45 IAC 3.1-1-8; 45 IAC 3.1-1-8(1); 45 IAC 3.1-1-153; 45 IAC 3.1-1-153(b).

Taxpayer challenges the audit's decision to disallow a deduction for interest attributable to federal obligations.

V. Losses Attributable to Non-Unitary Partnerships.

Authority: IC 6-3-2-2; Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999).

Taxpayer maintains that the audit erred in excluding, as non-business income, certain business losses attributable to partnerships.

VI. Business / Non-Business Income – Adjusted Gross Income Tax.

Authority: IC 6-3-1-20; IC 6-3-1-21; May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30.

Taxpayer argues that money received from the sale of a business division, money received from a settlement agreement with its insurance providers, and money received in the form of royalty payments, is "non-business" income.

VII. Calculation of Taxpayer's Foreign Source Income – Exclusion of Related Expenses.

Authority: IC 6-3-1-3.5(b); IC 6-3-2-12; IC 6-3-2-12(b); IC 6-3-2-12(c) to (e).

Taxpayer challenges the audit's calculation of the expenses related to taxpayer's acquisition of foreign source income; taxpayer maintains that the audit overstated the amount of those expenses.

VIII. Apportionment Sales Factor – Adjusted Gross Income.

Authority: Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-50(5); 45 IAC 3.1-1-55(e);

Taxpayer maintains that, for purposes of the calculating the sales denominator, the receipts generated by intangible personal property should be included.

IX. Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that it is entitled to request the Department to abate the ten-percent negligence penalty because it acted with reasonable care in determining its tax liability; taxpayer states that it cooperated fully with the audit and that the grounds for its subsequent protest were supported by a reasonable interpretation of the law.

STATEMENT OF FACTS

Taxpayer is in the business of manufacturing, distributing, and selling various paints and paint coatings. It sells these products to professional, industrial, commercial, and retail customers. Taxpayer operates a manufacturing facility in Indiana. An audit was conducted during which taxpayer's business records and tax returns were reviewed. The audit determined taxpayer owed additional corporate income tax. Taxpayer disagreed with certain of the audit's conclusions and submitted a protest to that effect. An administrative hearing was held during which taxpayer explained the basis for its protest, and this Letter of Findings follows.

DISCUSSION

I. **Estimated Rent Expenses** – Adjusted Gross Income Property Factor.

Pursuant to 45 IAC 3.1-1-43, the numerator in the property factor includes the average value of taxpayer's Indiana property used to produce business income. Accordingly, the audit estimated the capitalized rent expense associated with taxpayer's Indiana manufacturing plant in determining the taxpayer's numerator used in turn to calculate taxpayer's adjusted gross income tax.

Taxpayer argued that the audit's estimate of rent expense was excessive and requests that the "doubling up of an incorrect rent expense amount be excluded from the property factor information for all years." To that end, taxpayer has provided one page of a lease agreement purporting to establish that the amount of actual rent expense was substantially less than the amount estimated by the audit.

Under IC 6-8.1-5-1(b), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Taxpayer has provided a single page of a multi-page lease agreement. The document does not identify the leased property nor set out the terms of the lease. Taxpayer fails to meet its burden of demonstrating that the proposed assessment is incorrect.

FINDING

Taxpayer's protest is respectfully denied.

II. **Property and Inventory Factors** – Adjusted Gross Income.

The audit adjusted the property numerator to reflect the value of a distribution center and the inventory contained at that center. Taxpayer's distribution center was closed in 1994 and was later sold. Taxpayer maintains that the "amount by which the factors were increased appears to be too high, due to the fact that the entire amount was added to the average balance calculated on the return."

IC 6-3-2-2(c) states in part that, "The average of property shall be determined by averaging the values at the beginning and ending of the taxable year but the department may require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the taxpayer's property." The audit determined the value of the property based upon the ten months during which taxpayer owned the distribution center. The audit determined the value of the inventory based upon the five months during which inventory was maintained at the distribution center. Taxpayer has suggested no alternative method for determining the value of the distribution center and its inventory but merely suggests that the amounts "appear to be too high."

Under IC 6-8.1-5-1(b), taxpayer has failed to demonstrate whatsoever that the audit erred in its assessment of the distribution center's property value and has failed to propose an alternate, justifiable valuation.

FINDING

Taxpayer's protest is respectfully denied.

III. Installation and Delivery Receipts – Gross Income Tax.

Taxpayer operates retail stores. Customers can purchase carpeting and other floor covering materials from these retail stores. When they do so, the customers can also make arrangements for the delivery and installation of the floor coverings directly with the retail stores. The customers pay the retail stores for the delivery and installation charges. Thereafter, the retail stores arrange with independent contractors to undertake the actual delivery and installation work. The retail stores then pay the independent contractors for the completed work.

The audit determined that the money received from the retail customers was subject to the state's gross income tax at the high rate. Taxpayer disagrees arguing that the delivery and installation receipts were merely "pass through" income.

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary or Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indiana, the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2). However, 45 IAC 1.1-6-10 exempts that portion of a taxpayer's income which the taxpayer receives when acting in an agency capacity. 45 IAC 1.1-1-2 defines an "agent" as follows:

> (a) "Agent" means a person or entity authorized by another to transact business on its behalf.
>
> (b) A taxpayer will qualify as an agent if it meets both of the following requirements:
>
> > (1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.
> >
> > (2) The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through, actually or substantively, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

Taxpayer maintains that the audit's decision to count as gross receipts the money received for delivery and installation charges was made "arbitrarily" and that "the original return accurately calculated the gross income based on Indiana law." However, taxpayer has provided nothing which would warrant a conclusion that this money was accepted by the retail stores while acting in an agency capacity on behalf of the various independent contractors. There is nothing to indicate that taxpayer's retail stores were "under the control of" the independent contractors or that the parties ever intended to enter into an agency relationship; there is nothing to establish that the retail stores did 'not have [a] right title, or interest in the money or property received from the transaction. Id. The taxpayer's bare assertion to the contrary "is insufficient to establish an agency relationship." Id.

The retail stores received money for the delivery and installation of carpeting and floor coverings. The audit correctly determined that income obtained from the provision of these services was subject to the gross income tax at the high rate pursuant to IC 6-2.1-2-3 and IC 6-2.1-2-5(9).

FINDING

Taxpayer's protest is respectfully denied.

IV. Deduction for Interest on Federal Obligations.

The audit made an adjustment to reduce to zero amounts taxpayer deducted as government interest. Taxpayer disagrees arguing that, pursuant to U.S. Const. art. VI, § 2,

the interest from the federal obligations is immune from Indiana taxes and that the deduction should be reinstated.

With respect to corporate taxpayers, 45 IAC 3.1-1-8 states that "Adjusted Gross Income" is taxable income as defined in I.R.C. § 63 but specifies certain adjustments including the requirement to "Subtract income exempt from tax under the Constitution and Statutes of the United States." 45 IAC 3.1-1-8(1).

The audit determined that certain of this interest income could not be deducted because the interest was received by "non-unitary partnerships." In part, these partnerships represent investments in low-income housing, in an "environmental" partnership, and in an executive benefit trust.

The Indiana Tax Court has stated that a corporate partner's income is determined by apportionment at the corporate partner's level when the corporate partner and the partnership have a unitary relationship. Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766, 778 (Ind. Tax Ct. 1999). The court made its decision based on the application of IC 6-3-2-2 and appeared to find that 45 IAC 3.1-1-153 was a reasonable application of the apportionment statute. Id. at 777. In applying IC 6-3-2-2 to corporate partnerships, the court stated:

> If the income from the partnerships constitutes business income (i.e. if the affiliated group and the partnerships are engaged in a unitary business) under section 6-3-2-2, all of that income would be subject to apportionment based on an application of the affiliated group's property, payroll, and sales factors. If the income from the partnerships constitutes non-business income for the affiliated group *(i.e. if the affiliated group and the partnerships are not engaged in a unitary business), that income would be allocated to a particular jurisdiction*. Id at 776. (*Emphasis added*).

The court plainly states that all of a corporate partner's income from a partnership with a unitary relationship to that partner is business income and further states that all of a corporate partner's income from a partnership with a non-unitary relationship is non-business income. This means that there is no business / non-business distinction at the partnership level regardless of the relationship between the partner and the partnerships. While the income from a non-unitary partnership will be non-business income, it is not wholly allocated to a single state. The allocation is based on an apportionment of all partnership income at the partnership level. Although 45 IAC 3.1-1-153(c) uses the term "business income" to describe the partnership income to be allocated through a factor apportionment, this description does not result in a characterization of that income as "business income" that flows through to the corporate partner. Such an interpretation would contradict the Court's findings in Hunt. Id. at 776.

It is unnecessary to determine whether taxpayer would be entitled to benefit from the exempt character of this income if taxpayer enjoyed a unitary relationship with the partnerships. Rather, the question can be resolved by determining the threshold

unitary/non-unitary question. Does taxpayer have a unitary relationship with the low-income housing, environmental, and executive benefit partnerships?

45 IAC 3.1-1-153 is determinative of whether or not a unitary relationship exists. "If the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula . . . ." 45 IAC 3.1-1-153(b). Therefore, in order to establish a unitary operation, the taxpayer must demonstrate that the relationship between itself and the partnership meet the established standards of a unitary relationship.

The unitary principal has been addressed repeatedly by the Supreme Court; while no single definition exists, one characteristic appears to be essential – day-to-day operational control. Allied-Signal, Inc. v. Director, Div. Of Taxation, 504 U.S. 768 (1992); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 166 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982). To establish that taxpayer does have a unitary relationship with the partnerships, taxpayer must establish taxpayer has operational control of the partnerships or that management of the partnerships is centralized with the taxpayer.

Taxpayer has provided nothing to establish that it has a unitary relationship with the low-income housing, "environmental," and executive benefit trust partnerships. Taxpayer is not entitled to deduct the federal interest amounts attributable to those partnerships.

Taxpayer also claims it is entitled to deduct government interest attributable to a fourth partnership. Taxpayer identifies this partnership and its interest income as "T-X." However, taxpayer has provided nothing which establishes this income was received in the form of exempt government interest or that it has a unitary relationship with "T-X." Taxpayer has failed to meet its burden of demonstrating the audit erred in its conclusion that taxpayer was not entitled to deduct the interest income received from the four categories of partnership interests.

FINDING

Taxpayer's protest is respectfully denied.

V. Losses Attributable to Partnerships.

Taxpayer included in its federal adjusted gross income losses attributable to the "environmental" and low-income housing partnerships. The audit made an adjustment to taxpayer's federal adjustment gross income which deducted the results of these two partnerships.

In order for taxpayer to bring the partnership losses within the apportionment provisions of IC 6-3-2-2, the taxpayer must first demonstrate the income (or losses) are attributable to a partnership with which it has a unitary relationship. Hunt, 709 N.E.2d at 776.

Taxpayer merely asserts that the audit erred in its "classification of [taxpayer's] partnership interest as nonbusiness." The Department has no basis for disagreeing with the audit's conclusion that the losses attributable to the "environmental" and low-income housing partnerships were received from non-unitary sources. The losses are not attributable to Indiana but are allocated elsewhere.

FINDING

Taxpayer's protest is respectfully denied.

VI. Business / Non-Business Income – Adjusted Gross Income Tax.

Taxpayer maintains that the audit erred in classifying three specific categories of income as "business income." Specifically, taxpayer argues that money received from the sale of a business subsidiary, money received from insurance settlements, and money received in the form of royalty payments should be classified as "non-business income."

The audit reclassified the income received from these three sources as "business income" subjecting the income to apportionment and taxation. IC 6-3-1-21.

"Business income" and "non-business income" are defined by the Indiana Code as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operation. IC 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." IC 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001). In that decision, the Tax Court determined that IC 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. Id. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* IC 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.

(3) The frequency, number of continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

A. Insurance Settlement.

Taxpayer owns and operates certain manufacturing locations. A number of its insurance carriers proposed – and taxpayer accepted – to offer an amount of money in order to settle anticipated claims for environmental property damage at these manufacturing locations. Taxpayer maintains that it is in the business of manufacturing and selling paint and not in the business of accepting insurance settlements. Accordingly, taxpayer argues that the settlement money was "non-business" income and should be allocated elsewhere.

Taxpayer owned and operated the sites in order to manufacture paint. Any environmental damages – which may or may not have occurred at these locations – presumably occurred because of the manufacturing activities. Taxpayer purchased insurance in order to assure that it would be compensated in the event this property was damaged or in the eventuality taxpayer would be held liable for that damage in the future. Taxpayer and its insurance carriers, for whatever reason, chose to anticipatorily settle any undiscovered property loss claims. The fact that taxpayer does not regularly receive insurance settlements and that taxpayer is not in the business of accepting insurance settlements is of no consequence. *See* May, 749 N.E.2d at 665; 45 IAC 3.1-1-30. The money received from the insurance

settlements was "income arising from transactions and activity in the regular course of the taxpayer's trade or business business . . . ." IC 6-3-1-20.

B. Royalty Payments.

Taxpayer develops and owns proprietary paint formulas. Taxpayer owns various foreign subsidiaries and participates in joint ventures with other paint manufacturers. Taxpayer licenses paint formulas for use by these subsidiaries and joint ventures. Taxpayer also licenses the formulas to independent foreign entities. In addition, taxpayer licenses trademarks and trade names to the subsidiaries, joint ventures, and independent entities. The audit determined that the money received in the form of royalty payments was properly classified as business income and imposed additional tax liability accordingly.

Taxpayer disagrees stating that it does not have a unitary relationship with these foreign businesses or with its own licensing division and that the royalty payments are not business income.

Taxpayer is correct in its assertion that, in order to quality as business income, the money must be received by an entity with which it has a unitary relationship. "[I]f the taxpayer's activities carried on with the state are not unitary with its activities carried on elsewhere, the state is constitutionally constrained from including the property, income, or receipts arising from those out-of-state activities in the taxpayer's apportionable tax base." May, 749 N.E.2d at. 657 n.8.

Taxpayer misapprehends the relevance of its unitary relationship with the foreign licensees. The issue is not whether taxpayer has a unitary relationship with the related foreign businesses. The income received by the foreign licensees is irrelevant to the issue raised by taxpayer because there is no contention that the money received *by* the foreign businesses constitutes taxpayer's own income. Instead, the issue is whether or not the money *taxpayer* received in the form of royalty payments is business income.

Taxpayer maintains that the paint formulas and related trademarks are unique to each particular foreign market and are not used in its domestic market. For example, taxpayer points to the fact that certain of the paint formulas contain ingredients which are not permitted for use in the United States. Other paint formulas are adapted for to meet the unique weather conditions in the foreign markets. As taxpayer states, "these formulas were of no value in the United States and did not further domestic business." Taxpayer arrives at the conclusion that the royalty income should be "characterized as investment assets rather than operational assets."

Taxpayer is in the business of manufacturing and selling paint. Ancillary to those activities, taxpayer adapted or developed paint formulas and related proprietary trademarks. Taxpayer entered into licensing agreements with various foreign businesses to permit the businesses to make use of the formulas and trademarks. In return, taxpayer received royalty payments. The royalty income falls squarely within the definition of "business income" because the royalty income "[arose] from transactions and activity in

the regular course of the taxpayer's trade or business." IC 6-3-1-20. Under the statute, "business income" specifically "includes income from tangible and intangible property [when] the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations."

C. Sale of Subsidiary's Stock.

Taxpayer acquired a parent company and its subsidiaries. According to taxpayer, in acquiring the parent company, it was required to purchase all of the parent company's subsidiaries; it could not pick-and-choose those subsidiaries which it wished to acquire and retain. Thereafter, taxpayer sold the stock of one of these subsidiaries thereby divesting itself of ownership of this particular subsidiary.

The audit determined that the money received from the sale of this subsidiary's stock constituted "business income." Taxpayer disagrees maintaining that the stock sales constituted "non-business income." To that end, taxpayer points out that it never intended to retain ownership of this subsidiary. The subsidiary was never incorporated into taxpayer's own business operations but continued to be operated as a separate business. The subsidiary retained its original employees, retained the original management staff, and continued operations at the subsidiary's original location.

In May, the court found that the transactional test was not met when the retailer taxpayer sold a retailing division to a competitor because the retailer taxpayer was not in the business of selling entire divisions. May, 749 N.E.2d at. 664. Under the taxpayer's own circumstances, it is not in the business of buying and selling unrelated subsidiary companies. Therefore, the sale of the subsidiary's stock does not meet the transactional test.

The functional test focuses on the property being disposed of by the taxpayer. Id. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." Id. at 664-65. The court concluded that petitioner retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. Id. Therefore, the proceeds from the division's sale were not business income under the functional test. Id.

Taxpayer is in the business of manufacturing and selling paint. Taxpayer did not specifically intend to acquire this particular subsidiary and disposed of the asset less than one year after having done so. The subsidiary was never incorporated into taxpayer's own

business operation but remained an independent entity until it was sold. The taxpayer's acquisition and subsequent sale of the subsidiary's stock was not a constituent function necessary or integral to complete the whole of taxpayer's business. Therefore, the sale of the subsidiary's stock is not business income under the functional test.

The Department agrees with taxpayer and concludes that the income derived from the sale of the subsidiary should be classified as non-business income.

FINDING

Taxpayer's protest is sustained in part and denied in part. The money received from the sale of the subsidiary's stock constitutes non-business income; the remainder of the income at issue is properly classified as business income.

VII. Calculation of Taxpayer's Foreign Source Income – Exclusion of Related Expenses.

Taxpayer maintains that the audit overestimated the amount of expenses it incurred in earning foreign source dividend income.

In calculating taxpayer's state adjusted gross income tax liability, the starting point is the taxpayer's own federal adjusted gross income. IC 6-3-1-3.5(b) states that Indiana adjusted gross income is same as "taxable income" as defined in I.R.C. § 63. Thereafter, the amount of federal "taxable income" is subject to certain adjustments. Specifically, IC 6-3-2-12(b) states:

> A corporation that includes any foreign source dividend includes in the corporation's adjusted gross income for the taxable year; multiplied by the percentage prescribed in subsection (c), (d), or (e), as the case may be.

The aforementioned subsections (c), (d), and (e) allow corporate taxpayers to receive a one hundred (100%) deduction for foreign source dividends received from corporations in which a taxpayer has an eighty (80%) or larger ownership interest; an eighty-five percent (85%) deduction for dividends received from corporations in which a taxpayer has a fifty to seventy-nine percent (50% to 79%) ownership interest; and a fifty percent (50%) deduction for dividends received from corporations in which a taxpayer has less than a fifty percent (50%) ownership interest. IC 6-3-2-12(c) to (e).

The statutory language is cogent and clear. IC 6-3-2-12 authorizes pro rata deductions – based on the percentage ownership of the payor by the payee – of certain foreign source dividend income.

FINDING

Taxpayer's protest is sustained.

VIII. Apportionment Sales Factor – Adjusted Gross Income.

Taxpayer argues that the audit erred in excluding certain income from the sales factor. According to taxpayer, receipts "generated by intangible personal property that produced business income" should have been included in the numerator and denominator of the sales factor. In support of its position, taxpayer cites to 45 IAC 3.1-1-55(e) which states that, "Gross receipts from intangible personal property shall, if classified as business income, be attributed to this state based upon the ratio which the total property and payroll factors in this state bears to the total of the property and payroll factors everywhere . . . ." In effect, taxpayer argues that gross receipts equals the amount received on the sale of investment securities including both the interest earned and the principal.

The audit excluded from the sales denominator the "principal returned in short term securities transactions." The audit was correct in doing so. 45 IAC 3.1-1-50(5) states that, "In some cases, certain gross receipts should be disregarded in determining the sales factor to effectuate an equitable apportionment." Taxpayer may not include the return of principal realized each time it sells investment securities because the inclusion of both the principal and interest in each rollover amount would distort the sales factor by giving extra weight to its out-of-state sales.

The Indiana Tax Court has previously addressed this legal argument and ruled that, "'Gross Receipts' for the purpose of the sales factor includes only the interest income, and not the rolled over capital or return of principal, realized from the sale of investment securities." Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849, 853 (Ind. Tax Ct. 1996). The Tax Court spoke clearly and definitively, and the Department will not re-weigh its decision.

FINDING

Taxpayer's protest is denied.

IX. Ten-Percent Negligence Penalty.

The audit concluded with the recommendation that a ten-percent negligence penalty be assessed. Taxpayer argues that the Department should exercise its discretion to abate the penalty because it paid the correct amount of tax due in a timely manner, cooperated fully with the audit, and that its legal positions represented by the tax returns were supported by a reasonable interpretation of the applicable law and regulations.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department is unable to agree with taxpayer's argument that its original returns represented a reasonable interpretation of the law and that, in preparing those original returns, it "exercised ordinary business care." Its decision to include the principal received from the sale of investments accounted for more than 60 percent of its additional tax liability. The question of whether the gross proceeds generated by investment activity should be included in the sales factor has twice been protested, twice denied, and unsuccessfully litigated at the appellate court level. Nonetheless, during a third audit cycle, taxpayer proceeded to include the gross investment receipts in its sales factor. This decision, coupled with the fact that taxpayer now raises the identical issue in yet a third protest, is not indicative of the "reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b).

FINDING

Taxpayer's protest is denied.

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